Internal Revenue Service

memorandum

CC:EL:GL:ICPlucinski
GL-121813-97

date: MAR -6 1998

to: National Director, Submission Processing T:S

from: Assistant Chief Counsel (General Litigation) CC:EL:GL

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subject: Nonrebate Erroneous Refunds -- Additional Issues

This responds to your request for advice, dated December 17, 1998 (sic), and received by our office on February 6, 1998, regarding the impact of recent federal circuit court decisions on the Internal Revenue Service's ("Service") procedures governing collection of nonrebate erroneous refunds.

ISSUES

1. Whether the IDRS 510C Letter and the Form 4728 are considered collection notices.

2. Whether the IDRS 510C Letter and the Form 4728, as currently drafted, may still be used to solicit voluntary repayment of an erroneous refund.

3. What is the definition of an erroneous refund.

4. What is the definition of a rebate erroneous refund.

5. What is the definition of a nonrebate erroneous refund.

6. What is the statute of limitations for collection of a nonrebate erroneous refund, and under what conditions may the Service pursue the 10-year Collection Statute Expiration Date.

7. Under what circumstances may the Service rely on the five-year statute of limitations in I.R.C. § 6532(b) to recover a nonrebate erroneous refund.

8. May the Service continue to "revive" previously paid assessments.

CONCLUSIONS

1. The IDRS 510C Letter and the Form 4728 are not collection notices.

2. The IDRS 510C Letter and the Form 4728 may be used to solicit voluntary repayment of an erroneous refund. The Service's use of these letters, however, is restricted to the two or the five-year statute set forth in I.R.C. § 6532(b). Please note that before the Service intends to rely on the five-year statute to solicit a voluntary repayment, the Service should coordinate the case with the local District Counsel.

3. An erroneous refund includes any receipt of money from the Service to which the recipient is not entitled regardless of whether the recipient is the taxpayer or a third party.

4. A rebate refund occurs when the Service reduces or abates part of the taxpayer's liability on the basis that the correct tax liability is less than the amount previously assessed or reported by the taxpayer. See I.R.C. § 6211(b)(2).

5. A nonrebate erroneous refund is a refund resulting not from the redetermination of a taxpayer's liability, but rather from a clerical or ministerial mistake.

6. With some exceptions, the Service will generally have two years from the time the taxpayer receives the erroneous refund to recover a nonrebate erroneous refund. Unless the Service has specific statutory authority to assess the erroneous refund, such as in a case of overstated income tax prepayment credits under I.R.C. § 6201(a)(3) (category B refunds), the Service may not rely on the ten-year collection statute to collect a nonrebate erroneous refund.

7. The Service may rely on the five-year statute of limitations to recover a nonrebate erroneous refund if any part of the refund was caused by fraud or misrepresentation of a material fact. The Service has the burden of proving that the refund was induced by "fraud" or "misrepresentation of a material fact." Therefore, it is imperative that before the Service takes any action to recover an erroneous refund after the two-year period, the Service first coordinate the case with its local District Counsel.

8. No. In light of the overwhelming adverse case law, the Service may not use its current erroneous refund procedures set forth in IRM 3.17.79.16 to recover nonrebate erroneous refunds (category D refunds). Any continuation of the practice of "reviving" previously paid assessments and taking enforced collection actions to recover nonrebate erroneous refunds will subject the Service to damages under I.R.C. §§ 7431, 7432, and 7433.

DISCUSSION

Use of IDRS 510C Letter and the Form 4728

As requested, we have previously reviewed Letter 510C and Form 4728 and concluded that the Service may continue to use both of these documents to solicit voluntary repayment of an erroneous refund. The Service's use of these letters, however, is restricted to the two or the five-year statute set forth in I.R.C. § 6532(b).

Definition of an erroneous refund

The term "refund" within the phrase "erroneous refund" refers to any return of money, whether or not that money has previously been paid in. See, e.g., United States v. Steel Furniture Co., 71 F.2d 744 (6th Cir. 1935) (erroneous payment of interest on a valid refund constitutes an erroneous refund for purposes of I.R.C. § 7405). An "erroneous" refund includes any receipt of money from the Service to which the recipient is not entitled, regardless of whether the recipient is the person whom the Service intended to received the refund or, whether the recipient is a taxpayer, or a third party. For example, a multiple filer who submitted bogus returns in the names of other taxpayers, forging their signatures, received "erroneous refunds" for purposes of I.R.C. §§ 7405, 6532(b), 6602, and 6404(e)(2). See, e.g., deRochemont v. United States, 91-1 U.S.T.C. ¶ 50,237 (Cl. Ct. 1991).

Definition of a rebate erroneous refund

The definition of a "rebate" refund is statutory. See I.R.C. § 6211(b)(2). A rebate refund occurs when the Service reduces or abates the taxpayer's liability on the basis that the correct tax liability is less than the amount previously assessed or reported by the taxpayer on the return. To recover a rebate erroneous refund, a new determination of the taxpayer's liability, either administrative or judicial, must take place. If an administrative approach is taken, the Service will

generally have to follow deficiency procedures and make a new or supplemental assessment within the applicable assessment period. See I.R.C. §§ 6204; 6211 et seq., and 6501. Once a new assessment is made, the Service will have 10 years from the date of the assessment to collect on the assessment. I.R.C. § 6502. Alternatively, the Service may institute either a suit to reduce the liability to judgment (brought within the assessment period) or an erroneous refund suit pursuant to section 7405 of the Internal Revenue Code ("Code") (brought within the period of limitations set fourth in section 6532(b)).

Definition of a nonrebate erroneous refund

A "nonrebate" erroneous refund occurs not as a result of a redetermination of the taxpayer's liability, but rather, as a result of a clerical or ministerial error. There are a myriad of different errors that can lead to an issuance of a nonrebate erroneous refund. The following list contains a few examples of nonrebate erroneous refunds. It is not an exclusive list of circumstances that may lead to an issuance of a nonrebate erroneous refund. Thus, a nonrebate erroneous refund can occur as a result of:

1. A credit being posted to the wrong TIN;

2. A designated payment being posted to the wrong module;

3. A typographical error in imputing information, such as crediting taxpayer's module in an amount of $4,000 for a $400 payment;

4. Issuance of a duplicate refund check;

5. Erroneous release of computer frozen credits or payments;

6. Refunds issued after the statute of limitation on refund claims has expired. 1/

1/ Please note that there are other erroneous refunds, which, strictly speaking, may fall under the definition of nonrebate erroneous refund, but can be recovered under the Service's assessment procedures. See, e.g., Brookhurst v. United States, 931 F.2d 554 (9th Cir. 1991) (supplemental assessment under I.R.C. § 6402. See also I.R.C. § 6201(a)(3) (summary assessment of overstated income tax prepayment credits).

The distinction between what is a clerical error as opposed to a determination of a correct tax liability is critical in determining whether an erroneous refund is of a rebate or nonrebate variety, and determining what legal remedies are available to the Service to recover the refund. See, e.g., Singleton v. United States, 128 F.3d 833 (4th Cir. 1997).

Means of Recovery

Nonrebate erroneous refunds (currently classified as category D refunds) can only be recovered through voluntary repayment, civil suit, or right of offset. 2/ The Service may not initiate any enforcement collection procedures to recover a nonrebate erroneous refund (category D). Thus, the Service may not file a Notice of Federal Tax Lien, or issue a levy or notice of seizure for the amount erroneously refunded. The Service may, however, continue to administratively collect any unpaid portion of the original assessment, regardless of whether an erroneous refund was generated on the particular tax module in question. 3/

With the exception of the Service's right to setoff pursuant to Lewis v. Reynolds, 248 U.S. 281 (1932), the Service's remedies for recovery of nonrebate erroneous refunds are subject to the time limitations set forth in I.R.C. § 6532(b). This section provides:

> Recovery of an erroneous refund by suit under section 7405 shall be allowed only if such suit is begun within 2 years after the making of such refund, except that such suit may be brought at any time within 5 years from the making of the refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

I.R.C. § 6532(b).

2/ We are still exploring [redacted] DP

3/ This concept will be discussed in more detail later in the memorandum.

While section 6532(b) refers only to the filing of an erroneous refund suit under section 7405, it is our position that the Service's common-law right of offset is likewise limited to the two-year, or where applicable the five-year, limitations period. See generally, United States v. Munsey Trust Co., 332 U.S. 234 (1947); Cherry Cotton Mills, Inc. v. United States, 325 U.S. 536 (1946); Crocker First Nat'l Bank v. United States, 137 F. Supp. 573 (N.D. Cal. 1955). But see Moran v. United States, 953 F. Supp. 354, 357 (N.D. Okl. 1996). Accordingly, the Service may recover a nonrebate erroneous refund by the following means:

1. The Service may solicit a voluntary repayment of the erroneous refund within two or five years from the issuance of the erroneous refund.

2. The Service may offset the liability resulting from the erroneous refund against a refund due to the taxpayer with respect to any tax year or any type of tax if the offset is made within two or five years from the erroneous refund. I.R.C. § 6532(b). 4/

3. The Service may obtain a judgment against the taxpayer by filing an erroneous refund suit pursuant to I.R.C. § 7405. In order to be timely, an erroneous refund suit must be filed within two, or five, years from the date the taxpayer received the erroneous refund. See O'Gilvie v. United States, 117 S. Ct. 452 (1996). In addition, before an erroneous refund suit can be initiated, the amount sued for (i.e. the amount of the erroneous refund plus accrued interest) must exceed the litigation limit established by the Department of Justice. 5/

4. The Service may also offset the amount erroneously refunded to the taxpayer against a refund due to the taxpayer with respect to the same type of tax and the same year (i.e. refund due on the same module). There is no time limitation on this right of offset. See Lewis v. Reynolds, 248 U.S. 281 (1932).

4/ [redacted]

5/ Please note that the Service need not meet the established litigating threshold when counterclaiming for an erroneous refund in a refund suit filed by the taxpayer.

Additionally, as expressed to you in our memoranda dated January 22, January 23, and January 30, 1998, the Service may assess, within the applicable assessment period, category B refunds. Category B refunds are erroneous refunds caused by "the taxpayer's overstatement of withholding or estimated tax payments on his return." See I.R.C. §§ 6201(a)(3); 6501. This authority to assess is not limited by the amount of the original assessment (TC 150). Rather, when the taxpayer overstates the amount withheld at the source or paid as estimated income tax and the Service allows the amount so overstated as a credit against the tax due or refunds the overstated amount to the taxpayer, the Service may summarily assess the amount so overstated. I.R.C. § 6201(a)(3). Under this provision, the assessment should be made in the same manner as in a case of a mathematical or clerical error appearing upon the return, except that the "abatement" provisions set forth in section 6213(b)(2) do not apply. Also, the Service need not follow deficiency procedures. The Service must, however, notify the taxpayer of the new assessment within 60 days as required by I.R.C. § 6303(a).

The application of section 6201(a)(3) to category B refunds is best illustrated by using a couple of examples.

> Example 1: Facts: Taxpayer A reports on his Form 1040 tax due in the amount of $4,000 (TC 150) and withholding credits in the amount of $4,500 (TC 806). The Service refunds $500 to the taxpayer based on the information reported on the return. The Service later learns that the correct amount of withholding credits is only $3,800. What can the Service do? Conclusion: If the applicable assessment period is still open, the Service can assess the difference between the credits reported by the taxpayer ($4,500) and credits actually paid ($3,800). We understand that this will be accomplished by the use of the transaction code TC 807 (credit reversal) and transaction code TC 290 (adjustment to the assessment). The use of TC 290 will ensure that the taxpayer receives all required notices, including the notice and demand required by I.R.C. § 6303(a). Once the Service enters a timely assessment and issues a timely notice and demand for payment, the Service may use its normal collection procedures to collect the $700 assessment, plus any accrued interest.
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> Example 2: Facts: Taxpayer B reports a tax due in the amount of $1,000 and withholding and prepayment credits in the amount of $5,700. The taxpayer receives a refund of $4,700. After the refund is

issued, the Service discovers that the correct amount of withholding and prepayment credits was only $1,700. Thus, $4,000 of the $4,700 refund was erroneous. What can the Service do?
Conclusion: The Service may assess (using TC 807 and TC 290) and administratively collect the entire $4,000, even though this amount exceeds the amount of the original assessment ($1000). Section 6201(a)(3) assessment authority is not limited by the amount of the original assessment.

Statute of Limitations

You ask under what circumstances may the Service rely on the five-year, rather than the two-year, statute of limitations to recover an erroneous refund. The current manual provisions state that "if the erroneous refund is due to a taxpayer error" it can be collected "five years from the date of the refund." See IRM 21.8.6. Also 3.17.79.16.1.(3).b. This statement is incorrect. The Service may rely on the five-year statute only if "any part of the refund was induced by fraud or misrepresentation of a material fact." I.R.C. § 6532(b). The Service has the burden of proof on all of the elements of the erroneous refund. Soltermann v. United States, 272 F.2d 387 (9th Cir. 1959); United States v. Moreno, 80-2 U.S.T.C. ¶ 9536 (S.D. Fla. 1980). Therefore, before the Service can rely on the five-year period, the Service must have evidence that the refund was induced by fraud or a misrepresentation of a material fact. This can only be determined on a case by case basis. Accordingly, before the Service takes any action to recover the erroneous refund after the two-year period has expired, the Service must obtain District Counsel's opinion that the facts of the case justify reliance on the five-year statute.

As stated above, section 6532(b) provides that the Service may recover an erroneous refund within five years if "it appears that any part of the refund was induced by fraud or misrepresentation of a material fact." I.R.C. § 6532(b). Neither section 6532(b) or 7405, nor the regulations thereunder, define the term "fraud" or "misrepresentation of a material fact." See Treas. Reg. §§ 301.6532-3. Webster's Third New International Dictionary, however, defines fraud as "an intentional misrepresentation, concealment or nondisclosure for the purpose of inducing another ... to part with some valuable thing; a false representation of a matter of fact by words or conduct." Webster's Third New International Dictionary (Third Edition 1986). Hence, in order to show that an erroneous refund was "induced by fraud" the Service will have to show that the taxpayer made false representations,

concealed information, or failed to disclose important facts, with the intent of obtaining funds to which he or she was not entitled.

The Government's burden of proof with respect to the "misrepresentation of a material fact" is somewhat lower than in cases of "fraud." In United States v. Indianapolis Athletic Club, Inc., 785 F. Supp. 1336 (S.D. Ind. 1991), the court followed a three-part analysis proposed by the Government in determining whether an erroneous refund was "induced by fraud or misrepresentation of material fact." While the court accepted the Government's three-part test, it held that the refund at issue was not caused by the misrepresentation of a material fact. Instead, the court found that the Indianapolis Athletic Club's position that the charges in question constituted "tips" was a conclusion of law and not a misrepresentation of fact.

Before the Government can rely on the five-year statute of limitations as a result of a taxpayer's misrepresentation of a material fact, the Government must establish three things. First, the Government must show that a misrepresentation of fact was made. Second, the Government must show that the fact was material. Third, the Government must establish that the decision to issue the erroneous refund was induced by the misrepresentation. Indianapolis Athletic, 785 F. Supp. at 1337-38. We believe that this three-part test should be used by the Service when determining whether any part of the refund was caused by "misrepresentation of a material fact." In order to do so, the Service will have to determine whether the taxpayer to whom the erroneous refund was issued made a misrepresentation of fact; whether the fact was material; and whether the Service relied on the taxpayer's misrepresentation when it issued the erroneous refund.

Webster's Third New International Dictionary defines "misrepresentation" as "an untrue, incorrect, or misleading representation." Webster's Third New International Dictionary (Third Edition 1986). The representation can be in form of a statement, assertion, or a failure to disclose relevant information. The misrepresentation, however, must be regarding a fact that is material or essential to the Service's decision to issue the erroneous refund. In other words, before the Government can rely on the five-year statute, the Service has to establish that the decision to issue the erroneous refund was induced by the misrepresentation itself, and not by other surrounding circumstances. For example, a claim for a refund which was already refunded and received by the taxpayer (i.e. duplicate refund) constitutes a misrepresentation of fact and may be brought within the five-year limitations period.

See Merlin v. Sanders, 243 F.2d 821 (5th Cir. 1957). On the other hand, a refund claim merely filed after the limitations period expired does not, generally, constitute a "misrepresentation of a material fact." Similarly, the mere fact that a taxpayer's check is not honored by a bank does not rise to the level of misrepresentation for purposes of section 7405 unless the Service can show that the taxpayer knew that(s)he did not have sufficient funds to cover the check. Finally, when a taxpayer inadvertently uses a wrong coupon or provides incorrect information on a remittance, the taxpayer's mistake is not sufficient to trigger the five-year statute.

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Revival Theory

As stated in our April 16, 1997, memorandum, the Service may no longer collect nonrebate erroneous refunds by simply reversing the erroneous credit and/or abatement which caused the refund, and collecting the resulting balance due administratively. This reversal of credits and the subsequent reliance on the original assessment to collect the erroneous refund is commonly referred to as the "revival theory." Due to the overwhelming adverse case law on this issue, however, the Service may no longer legally use this theory or rely on its current erroneous refund procedures to collect nonrebate erroneous refunds. See, e.g., Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996); Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995); United States v. Wilkes, 946 F.2d 1143 (5th Cir. 1991); Stanley v. United States, 35 Fed. Cl. 493 (Ct. Cl. 1996).

Although the Service may no longer administratively collect nonrebate erroneous refunds, the Service may continue to collect the unpaid portion of the original assessment after the erroneous abatement and/or credit is reversed. See Wilkes, 946 F.2d at 1152. This concept is best illustrated by using an example. A taxpayer files a return and reports tax due in the amount of $10,000 (TC 150). Taxpayer makes a payment with the return of $7,000 (TC 610), but the Service erroneously credits the taxpayer's module twice, resulting in a refund of $4,000.

The Service discovers its mistake after the refund is issued. What are the Service's remedies? First, it is our position that the Service may reverse the erroneous credit after it discovers its mistake. See Clark, 63 F.3d at 89; In re Bugge, 99 F.3d 740 (5th Cir. 1996); Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D. N.Y. 1970). 6/ The Service may not, however, bill the taxpayer for the entire $7,000. The Service may bill the taxpayer only for $3,000 (the remaining balance due on the original assessment), plus any accruing interest and penalties. The amount which the Service may collect administratively, i.e. the $3,000, can be calculated by subtracting all proper credits and payments made by the taxpayer ($7,000) from the amount assessed ($10,000, plus any assessed interest and penalties). The amount erroneously refunded to the taxpayer ($4,000), however, can only be collected by using proper erroneous refund procedures described above.

In order to ensure that the Service maximizes its collection potential on modules containing erroneous refunds and that taxpayers receive bills in the correct amounts 7/, we recommend that the Service develop procedures which will enable all Service employees to quickly and correctly distinguish between the amount of the erroneous refund and the amount still due and owing on the original valid tax assessment. Under the current procedures, our taxpayer's module would show a balance due of $7,000. Although the module would contain an erroneous refund transaction code, TC 844 is a zero amount transaction which only enables the Service to identify a module containing an erroneous refund. TC 844 does not specify the amount of the erroneous refund nor the amount still due and owing on the original timely assessment. We believe it is imperative that the new erroneous refund procedures provide the Service with the ability to separate the amounts erroneously refunded from the amounts still due and owing on the original assessment. In other words, the Service should have the ability to separate by the use of

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6/ The Service's right to correct its own error, including erroneous and unauthorized abatements, is not limited by any statute of limitations. However, the Service may not correct its error if the correction would "prejudice the taxpayer." Crompton-Richmond, 311 F. Supp. at 1187. Prejudice to the taxpayer must be decided on a case by case basis.

7/ As stated above, we do not consider Letter 510C or Form 4728 to constitute "bills" for collection purposes.

different transaction codes the amount of erroneous refund which must be collected pursuant to the erroneous refund procedures and the amount which remains unpaid and can be collected administratively within the collection period.

As always, we hope the advice provided herein is helpful. If you have any questions or comments on how to implement this advice, please do not hesitate to contact Inga C. Plucinski at (202) 622-3620.

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JOYCE E. BAUCHNER

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